LED MEDICAL DIAGNOSTICS INC.

INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For the three months ended June 30, 2012 and 2011
(Unaudited and Expressed in Canadian Dollars)

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

Under National Instrument 51-102, Part 4, subsection 4.3(3) (a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indication that financial statements have not been reviewed by an auditor.

The accompanying unaudited interim condensed consolidated financial statements of the Company have been prepared by management and approved by the Audit Committee of the Board of Directors of the Company and the Board of Directors of the Company.

The Company's independent auditors have not performed a review of these interim condensed consolidated financial statements in accordance with the standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditors.

Peter Whitehead
Chief Executive Officer
August 14, 2012

LED MEDICAL DIAGNOSTICS INC.

Interim Condensed Consolidated Statements of Financial Position

(Unaudited and Expressed in Canadian Dollars)

	As at June 30, 2012	As at December 31, 2011
ASSETS		
CURRENT		
Cash and cash equivalents	**$ 767,677**	$ 992,360
Restricted cash *(Note 4)*	**5,000**	25,000
Receivables *(Note 5)*	**1,068,294**	303,800
Inventory	**408,990**	706,151
Prepayments	**93,807**	72,942
	2,343,768	2,100,253
PROPERTY AND EQUIPMENT *(Note 6)*	**45,423**	46,623
PATENTS AND INTELLECTUAL PROPERTY *(Note 7)*	**102,788**	115,910
	$ 2,491,979	$ 2,262,786
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
CURRENT LIABILITIES		
Trades payable and accrued liabilities *(Note 8)*	**$ 2,102,296**	$ 1,422,768
Due to shareholders *(Note 9)*	**-**	104,544
Current portion of capital lease obligation *(Note 11)*	**2,756**	2,478
	2,105,052	1,529,790
CAPITAL LEASE OBLIGATION *(Note 11)*	**8,689**	10,140
	2,113,741	1,539,930
SHAREHOLDERS' EQUITY		
Share capital *(Note 12)*	**24,116,479**	24,116,479
Stock-based payments reserve *(Note 13)*	**63,557**	63,557
Warrants reserve *(Note 14)*	**282,470**	282,470
Deficit	**(24,084,268)**	(23,739,650)
	378,238	722,856
	$ 2,491,979	$ 2,262,786

See accompanying notes to consolidated financial statements

LED MEDICAL DIAGNOSTICS INC.

Interim Condensed Consolidated Statements of Operations and Deficit and Comprehensive Income (Loss)

(Unaudited and Expressed in Canadian Dollars)

For the	**Three months ended June 30, 2012**	Three months ended June 30, 2011	**Six months ended June 30, 2012**	Six months ended June 30, 2011
SALES	**$ 1,792,407**	$ 1,507,004	**$ 3,621,398**	$ 4,565,959
COST OF GOODS SOLD	**675,294**	709,396	**1,456,896**	2,024,995
	1,117,113	797,608	**2,164,502**	2,540,964
EXPENSES *(Note 20)*				
Sales and marketing	**674,468**	1,011,966	**1,558,666**	1,723,617
Research and development	**142,626**	189,410	**316,787**	404,662
Administration	**253,194**	303,519	**594,007**	596,693
Other operating expenses *(Note 19)*	**13,263**	22,684	**30,694**	45,368
	1,083,551	1,527,579	**2,500,154**	2,770,340
OPERATING INCOME (LOSS)	**33,562**	(729,971)	**(335,652)**	(229,376)
OTHER INCOME (EXPENSES)				
Foreign exchange gain (loss)	**9,745**	77,259	**(11,032)**	102,335
Interest income	**-**	-	**287**	-
Loss on disposal of assets	**(702)**	-	**(702)**	-
Miscellaneous income (expenses)	**377**	8,024	**2,481**	8,024
	9,420	85,283	**(8,966)**	110,359
NET INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS) FOR THE PERIOD	**$ 42,982**	($ 644,688)	**($ 344,618)**	($ 119,017)
LOSS PER SHARE - BASIC AND FULLY DILUTED	**$0.00**	($0.02)	**($0.01)**	($0.00)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING – BASIC AND FULLY DILUTED *(Note 15)*	**36,335,508**	31,208,524	**36,335,508**	30,628,524

See accompanying notes to consolidated financial statements

LED MEDICAL DIAGNOSTICS INC.

Interim Condensed Consolidated Statements of Changes in Shareholders' Equity

(Unaudited and Expressed in Canadian Dollars)

	Share Capital (Restated - Note 21)	**Stock-based Payments Reserves**	**Warrants Reserve**	**Deficit (Restated - Note 21)**	**Total Shareholder's Equity**
Balance, January 1, 2012	**$24,116,479**	**$63,557**	**$ 282,470**	**($ 23,739,650)**	**$722,856**
Net comprehensive loss for the period	-	-	-	(387,600)	(387,600)
Balance, March 31, 2012	**$24,116,479**	**$63,557**	**$ 282,470**	**($ 24,127,250)**	**$335,256**
Net comprehensive incom for the period	-	-	-	42,982	42,982
Shares issued for cash	-	-	-	-	-
Balance, June 30, 2011	**$24,116,479**	**$ 63,557**	**$ 282,470**	**($ 24,084,267)**	**$378,238**
Balance, January 1, 2011	**$19,221,348**	**$1,550,460**	**$ 120,208**	**($ 21,702,119)**	**($810,103)**
Net comprehensive income for the period	-	-	-	525,671	525,671
Shares issued for cash	1,522,460	-	-	-	1,522,460
Balance, March 31, 2011	**$20,743,808**	**$ 1,550,460**	**$ 120,208**	**($ 21,176,448)**	**$1,238,028**
Net comprehensive incom for the period	-	-	-	(644,688)	(644,688)
Balance, June 30, 2011	**$20,743,808**	**$ 1,550,460**	**$ 120,208**	**($ 21,821,136)**	**$593,340**

See accompanying notes to consolidated financial statements

LED MEDICAL DIAGNOSTICS INC.

Interim Condensed Consolidated Statements of Cash Flows

(Unaudited and Expressed in Canadian Dollars)

For the	**Three months ended June 30, 2012**	Three months ended June 30, 2011	**Six months ended June 30, 2012**	Six months ended June 30, 2011
CASH FLOWS FROM OPERATING ACTIVITIES				
Net income (loss) for the period	**$ 42,982**	($ 644,688)	**($ 344,618)**	($ 119,017)
Adjustments to reconcile net loss to net cash flows:				
Depreciation of equipment	**6,702**	9,557	**17,572**	19,114
Amortization of intangible assets	**6,561**	13,127	**13,122**	26,254
Loss on disposal of assets	**702**	-	**702**	-
Accrued interest on shareholder loans	**-**	14,558	**2,586**	37,875
	56,947	(607,446)	**(310,636)**	(35,774)
Working capital adjustments:				
Receivables	**(957,740)**	2,106,620	**(764,494)**	(325,607)
Inventory	**(43,973)**	(13,045)	**297,161**	(347,417)
Investment tax credits recoverable	**-**	83,027	**-**	83,027
Prepayments	**16,255**	(94,855)	**(20,865)**	(81,743)
Trades payable and accrued liabilities	**778,445**	154,069	**679,528**	871,376
Income taxes payable	**-**	-	**-**	(10,713)
Deferred income	**-**	-	**-**	(3,250)
Changes in working capital assets and liabilities	**(207,013)**	2,235,816	**191,330**	185,673
Cash flows provided by (used in) operating activities	**(150,066)**	1,628,370	**(119,306)**	149,899
CASH FLOWS FROM INVESTING ACTIVITIES				
Purchase of equipment	**-**	-	**(17,074)**	(39,563)
Cash flows used in investing activities	**-**	-	**(17,074)**	(39,563)
CASH FLOWS FROM FINANCING ACTIVITIES				
Issuance of common shares, net of issuance costs	**-**	-	**-**	1,522,460
Repayment of capital lease obligation	**(601)**	(318)	**(1,173)**	(780)
Restricted cash	**-**	-	**20,000**	-
Repayment of shareholder loans	**-**	(81,028)	**(107,130)**	(356,028)
Cash flows provided by (used in) financing activities	**(601)**	(81,346)	**(88,303)**	1,165,652
CHANGE IN CASH AND CASH EQUIVALENTS	**(150,667)**	1,547,024	**(224,683)**	1,275,988
CASH AND CASH EQUIVALENTS – BEGINNING OF PERIOD	**918,344**	(2,026)	**992,360**	269,010
CASH AND CASH EQUIVALENTS – END OF PERIOD	**$ 767,677**	$ 1,544,998	**$ 767,677**	$ 1,544,998

See accompanying notes to consolidated financial statements

1. NATURE AND CONTINUANCE OF OPERATIONS

LED Medical Diagnostics Inc. ("LED" or the "Company") was incorporated under the British Columbia Business Corporations Act on July 17, 2002 as 651195 B.C. Ltd. and changed its name to LED Medical Diagnostics Inc. on August 20, 2003.

On February 24, 2011, and as accepted on November 21, 2011 by the TSX Venture Exchange (the "Exchange"), LED entered into a letter agreement (the "Agreement") with Searchlight Capital Corp. ("Searchlight"), a Capital Pool Company listed on the Exchange. The transaction resulted in the amalgamation of LED, its wholly-owned subsidiaries LED Dental Inc., LED Dental (US) Ltd., EMD Systems Ltd., Visiotech Diagnostics Inc. and Searchlight. On November 24, 2011, the Company began trading on the TSX Venture Exchange (trading symbol: LMD). The transaction was accounted for as an acquisition of Searchlight by LED. For purposes of these interim condensed consolidated financial statements, the "Company" is defined as the amalgamated entity.

The Company develops and commercializes medical devices based on its proprietary imaging platform to aid in the detection and treatment of disease in human tissues. The Company has developed, and markets, a device under the trade name VELscope®. The device is used in the dental industry to help identify oral soft tissue abnormalities including those which may be cancerous or precancerous and also to help define appropriate margins for surgical excision. The VELscope system consists of a combined light source and handpiece, and accompanying consumables used for each exam.

The Company's head office, principal address and records office are located at 235 – 5589 Byrne Road, Burnaby, British Columbia, Canada, V5J 3J1. LED's registered and records office is located at 2500 – 700 West Georgia Street, Vancouver, B.C. V7Y 1B3.

These consolidated financial statements have been prepared on a going concern basis which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future.

The continuing operations of the Company are dependent upon its ability to generate profitable operations in the future, and to continue to secure additional financing from lenders and shareholders. There can be no assurance that the Company will be successful in its efforts to raise additional financing or if financing is available, that it will be on terms that are acceptable to the Company.

Based on the Company's completion of the Searchlight transaction in 2011, its operating history, and its relationship with its stakeholders, Management expects that the Company will have sufficient capital to fund operations for the upcoming fiscal year. Further discussion of liquidity risk has been disclosed in Note 18. These interim condensed consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts and classification of liabilities that might be necessary should the Company be unable to continue operations as a going concern.

2. STATEMENT OF COMPLIANCE AND BASIS OF PRESENTATION

These interim condensed consolidated financial statements of the Company, approved by the Board of Directors on August 10, 2012, have been prepared in accordance with International Financial Reporting Standards ("IFRS") and their interpretations adopted by the International Accounting Standards Board ("IASB").

These interim condensed consolidated financial statements have been prepared in accordance with IAS 34, *Interim Financial Reporting*. These interim condensed consolidated financial statements have been prepared using the historical cost basis and the accounting policies set out below have been applied consistently to all periods presented in these interim condensed consolidated financial statements. Accordingly, these interim condensed consolidated financial statements do not include all disclosures required for annual financial statements and should be read in conjunction statements as at and for the year ended December 31, 2011.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of preparation

The interim condensed consolidated financial statements of the Company have been prepared on an accrual basis and are based on historical costs, modified where applicable. The interim condensed consolidated financial statements are presented in Canadian dollars unless otherwise noted.

Principles of consolidation

Subsidiaries are entities controlled by LED. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. The financial statements of the subsidiaries are prepared for the same reporting period as the parent company, using consistent accounting policies. Intra-group balances and transactions, and any unrealized income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements.

These interim condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries listed in the following table:

Name of Subsidiary	Country of Incorporation	Ownership Interest June 30, 2012	Ownership Interest December 31, 2011
LED Dental Inc.	Canada	100%	100%
LED Dental (US) Ltd.	USA	100%	100%

Inter-company balances and transactions, including unrealized income and expenses arising from inter-company transactions are eliminated on consolidation.

Significant accounting judgments, estimates and assumptions

The preparation of the Company's interim condensed consolidated financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities and contingent liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the reporting period. Estimates and assumptions are continuously evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. However, actual outcomes can differ from these estimates.

Areas requiring a significant degree of estimation and judgment relate to the determination of impairment of receivables, impairment of inventory, providing for amortization of equipment and intangible assets, providing for future warranty claims, going concern assessments, fair value of stock-based transactions and financial instruments, future obligations for commitments, estimates of investment tax credit recoverable, estimates of liabilities in respect of warranties and deferred income tax rates. Actual results could differ from these estimates.

Foreign currency translation

The functional currency of each of the Company's entities is measured using the currency of the primary economic environment in which that entity operates. The consolidated financial statements are presented in Canadian dollars which is the functional and presentation currency of the parent.The functional currencies of the subsidiaries are as follows:

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)

Name of Subsidiary	Functional currency ($)
LED Dental Inc.	Canadian
LED Dental (U.S.) Ltd.	U.S.

Foreign currency transactions are translated into functional currency using the exchange rates prevailing at the date of the transaction. Foreign currency monetary items are translated at the period-end exchange rate. Non-monetary items measured at historical cost continue to be carried at the exchange rate at the date of the transaction. Non-monetary items measured at fair value are reported at the exchange rate at the date when fair values were determined.

Exchange differences arising on the translation of monetary items or on settlement of monetary items are recognized in profit or loss in the statement of comprehensive income in the period in which they arise, except where deferred in equity as a qualifying cash flow or net investment hedge.

The financial results and position of subsidiaries whose functional currency is different from the Company's presentation currency are translated as follows:

- Assets and liabilities are translated at period-end exchange rates prevailing at that reporting date; and
- Income and expenses are translated at average exchange rates for the year.

Exchange differences arising on translation of foreign operations are transferred directly to the Company's foreign currency translation reserve in the statement of comprehensive income. These differences will be recognized in profit or loss in the year in which the operation is disposed.

Financial instruments

The Company classifies its financial instruments in the following categories: at fair value through profit or loss, loans and receivables, held-to-maturity investments, available-for-sale financial assets and financial liabilities. The classification depends on the purpose for which the financial instruments were acquired. Management determines the classification of its financial instruments at initial recognition.

Financial assets are classified at fair value through profit or loss when they are either held for trading for the purpose of short-term profit taking, derivatives not held for hedging purposes, or when they are designated as such to avoid an accounting mismatch or to enable performance evaluation where a group of financial assets is managed by key management personnel on a fair value basis in accordance with a documented risk management or investment strategy. Such assets are subsequently measured at fair value with changes in carrying value being included in profit or loss. Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and are subsequently measured at amortized cost. They are included in current assets, except for maturities greater than twelve (12) months after the end of the reporting period. These are classified as non-current assets.

Held-to-maturity investments are non-derivative financial assets that have fixed maturities and fixed or determinable payments, and it is the Company's intention to hold these investments to maturity. They are subsequently measured at amortized cost. Held-to-maturity investments are included in non-current assets, except for those which are expected to mature within twelve (12) months after the end of the reporting period.

Available-for-sale financial assets are non-derivative financial assets that are designated as available-for-sale or are not suitable to be classified as financial assets at fair value through profit or loss, loans and receivables or held-to-maturity investments and are subsequently measured at fair value. These are included in current assets. Unrealized gains and losses are recognized in other comprehensive income, except for impairment losses and foreign exchange gains and losses.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)

Non-derivative financial liabilities (excluding financial guarantees) are subsequently measured at amortized cost.

Regular purchases and sales of financial assets are recognized on the trade-date – the date on which the Company commits to purchase the asset.

Financial assets are derecognized when the rights to receive cash flows from the investments have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership.

At each reporting date, the Company assesses whether there is objective evidence that a financial instrument has been impaired. In the case of available-for-sale financial instruments, a significant and prolonged decline in the value of the instrument is considered to determine whether an impairment has arisen.

The Company does not have any derivative financial assets and liabilities.

Impairment of non-financial assets

The carrying amount of the Company's non-financial assets (which include equipment and patents and intellectual property) is reviewed at each reporting date to determine whether there is any indication of impairment. If such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss. An impairment loss is recognized whenever the carrying amount of an asset or its cash generating unit exceeds its recoverable amount. Impairment losses are recognized in the statement of comprehensive income.

The recoverable amount of assets is the greater of an asset's fair value less cost to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects the current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

An impairment loss is only reversed if there is an indication that the impairment loss may no longer exist and there has been a change in the estimates used to determine the recoverable amount, however, not to an amount higher than the carrying amount that would have been determined had no impairment loss been recognized in previous years. Assets that have an indefinite useful life are not subject to amortization and are tested annually for impairment.

Stock-based payments

The Company operates an employee stock option plan. Stock-based payments to employees are measured at the fair value of the instruments issued and amortized over the vesting periods. Stock-based payments to non-employees are measured at the fair value of goods or services received or the fair value of the equity instruments issued, if it is determined the fair value of the goods or services cannot be reliably measured, and are recorded at the date the goods or services are received. The corresponding amount is recorded to the option reserve. The fair value of options is determined using the Black–Scholes option pricing model which incorporates all market vesting conditions. The number of shares and options expected to vest is reviewed and adjusted at the end of each reporting period such that the amount recognized for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest.

Cash and cash equivalents

Cash and cash equivalents include highly liquid Canadian dollar denominated guaranteed investment certificates which are readily convertible to contracted amounts of cash without penalty. Cash equivalents are classified as held-for-trading and are recorded at fair value with realized and unrealized gains and losses reported in the statement of comprehensive loss.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)

Inventory

Inventory consists of finished goods and is valued at the lower of cost and net realizable value with the cost being determined on a first in, first out basis. Net realizable value represents the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

Property and Equipment

Property and equipment is stated at historical cost less accumulated depreciation and accumulated impairment losses.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognized. All other repairs and maintenance are charged to the statement of loss and comprehensive loss during the financial period in which they are incurred.

Gains and losses on disposals are determined by comparing the proceeds with the carrying amount and are recognized in profit or loss.

Depreciation is calculated on a straight-line method to write off the cost of the assets to their residual values over their estimated useful lives. The depreciation rates applicable to each category of equipment are as follows:

Office equipment	5 years	straight-line method
Computer equipment	3 years	straight-line method
Manufacturing tooling	2 years	straight-line method
Leasehold improvements	term of lease	straight-line method

Leases

Leases of equipment where substantially all the risks and benefits incidental to the ownership of the asset are transferred to entities in the Company are classified as finance leases.

Finance leases are capitalized by recording an asset and a liability at the lower of the fair value of the leased equipment or the present value of the minimum lease payments, including any guaranteed residual values. Lease payments are allocated between the reduction of the lease liability and the lease interest expense for the period.

Leased assets are depreciated on a straight-line basis over the shorter of their estimated useful lives or the lease term.

Lease payments for operating leases, where substantially all the risks and benefits remain with the lessor, are charged as expenses in the periods in which they are incurred.

Lease incentives under operating leases are recognized as a liability and amortized on a straight-line basis over the life of the lease.

Intangible assets

Intangible assets, which consist of patents, intellectual property and related know-how, have finite lives and are measured at cost less accumulated amortization and accumulated impairment losses. Amortization is calculated over their useful lives using the straight-line method and the following periods

Intangible assets are being amortized using the straight line method over a 13 year period commencing in 2004.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)

Research and development costs

Research costs are expensed as incurred. Development costs are expensed as incurred unless the specific criteria for deferral and amortization have been met. The Company capitalizes the costs for development meeting these criteria up to the date the project has reached commercial production. Incidental recoveries and sales of test products prior to commercial production are offset against capitalized costs. Prior to commercial production management reviews the carrying value of capitalized development costs and the Company records impairment charges as appropriate whenever events or changes in circumstances indicate an impairment may have occurred. To date, the Company has not capitalized any development costs.

Income taxes

Current income tax:
Current income tax assets and liabilities for the current period are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted, at the reporting date, in the countries where the Company operates and generates taxable income.

Current income tax relating to items recognized directly in other comprehensive income or equity is recognized in other comprehensive income or equity and not in profit or loss. Management periodically evaluates positions taken in the tax returns with respect to situations in which applicable tax regulations are subject to interpretation and establishes provisions where appropriate.

Deferred income tax:
Deferred income tax is provided using the balance sheet method on temporary differences at the reporting date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

The carrying amount of deferred income tax assets is reviewed at the end of each reporting period and recognized only to the extent that it is probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilized.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply to the year when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

Deferred income tax assets and deferred income tax liabilities are offset, if a legally enforceable right exists to set off current tax assets against current income tax liabilities and the deferred income taxes relate to the same taxable entity and the same taxation authority.

Warranty provision

The Company provides its customers with warranty protection on its products. The warranties cover a period of two years. The Company estimates warranty expense based on past experience and records a liability in respect of estimated future warranty costs. The actual cost that the Company may incur and the timing of the repairs to be carried out may differ significantly from the estimated accrual.

Unearned revenue

Unearned revenue is revenue received in the current accounting period relating to services that the Company will provide in future accounting periods.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)

Revenue recognition

Revenue from product and service sales is recognized when the amount is fixed or determinable, title has transferred or initial services have been performed, and collection is reasonably assured.

Royalty revenue is recognized when the right to receive a royalty has been established and collection is reasonably assured.

Research and development tax credits

Research and development tax credits are accounted for using the cost reduction method. Accordingly, tax credits are recorded as a reduction of the related expenses or the capitalized costs when recoverability is reasonably assured.

Segment reporting

The Company operates in a single geographical segment, being Canada, and a single reporting segment, being the development and commercialization of medical devices based on its proprietary imaging platform to aid in the detection and treatment of disease in human tissues.

Comprehensive income

Comprehensive income or loss includes unrealized gains and losses on any available-for-sale investments, none of which are included in the calculation of net income until realized.

Earnings per share

The Company presents basic and diluted earnings per share ("EPS") data for its common shares. Basic EPS is calculated by dividing the profit or loss attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the period, adjusted for its own shares held. Diluted EPS is determined by adjusting the profit or loss attributable to common shareholders and the weighted average number of common shares outstanding, adjusted for its own shares held, for the effects of all dilutive potential common shares. A dilutive share capital quantification was performed for the three months ended June 30, 2012 as the Company was in a net income position for the period above. A dilutive share capital quantification has not been performed for three months ended June 30, 2011 nor the six months ended June 30, 2012 and 2011 as the Company is in a net loss position for the periods resulting in an anti-dilutive effect.

Comparative figures

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the current year's consolidated financial statements.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)

Accounting standards issued but not yet effective

Accounting standards effective July 1, 2012

IAS 1 – Presentation of Financial Statements

In June 2011, the IASB amended IAS 1 by revising how certain items are presented in other comprehensive income. Items within other comprehensive income that may be reclassified to profit and loss will be separated from items that will not. The standard is effective for financial years beginning on or after July 1, 2012 with early adoption permitted. There are no additional significant impacts on the Company.

Accounting standards anticipated to be effective January 1, 2013

IFRS 9 – Financial Instruments: Classification and Measurement

IFRS 9 - *Financial Instruments: Classification and Measurement* was published and contained requirements for financial assets updating IFRS 7. Requirements for financial liabilities were added to IFRS 9 in October 2010. Most of the requirements for financial liabilities were carried forward unchanged from IAS 39. However, some changes were made to the fair value option for financial liabilities to address the issue of own credit risk. The Company does not anticipate this amendment to have a significant impact on its consolidated financial statements.

IFRS 10 – Consolidated Financial Statements

IFRS 10 – *Consolidated Financial Statements* requires that beginning January 1, 2012, a reporting entity should consolidate any investee that it controls. Control is the basis for consolidation for all types of investees. IFRS 10 also provides guidance on assessing control in circumstances where the assessment has proven to be difficult. IFRS 10 provides more guidance about the factors to consider in such structures that involve potential voting rights, agency relationships, relationships with structured entities and control without a majority of voting rights. The Company consolidation with its current subsidiaries and related consolidation decisions should be unaffected by the new consolidation model in IFRS 10.

IFRS 11 – Joint Arrangements

IFRS 11 – *Joint Arrangement* requires a venturer to classify its interest in a joint arrangement as a joint operation or a joint venture. The standard eliminates the use of the proportionate consolidation method to account for joint ventures. Joint ventures will be accounted for using the equity method of accounting while for a joint operation the venturer will recognize its share of the assets, liabilities, revenues and expenses of the joint operation. IFRS 11 supersedes SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers* and IAS 31 *Joint Ventures.* The effective date of this amendment is for annual periods beginning on or after January 1, 2013. The Company does not anticipate this amendment to have a significant impact on its consolidated financial statements.

IFRS 12 – Disclosure of Interest in Other Entities

IFRS 12 – *Disclosure of Interest in Other Entities* sets out disclosure requirements which begin January 1, 2013 for reporting entities that have an interest in a subsidiary, joint arrangement, associate or unconsolidated structured entity. There is no additional interest or disclosures required.

(Expressed in Canadian Dollars)

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)

Accounting standards issued but not yet effective (cont'd)

IFRS 13 – Fair Value Measurement

IFRS 13 - *Fair Value Measurement* is effective for annual periods beginning on or after January 1, 2013, with early adoption permitted, sets out in a single IFRS a framework for measuring fair value and new required disclosures about fair value measurements. Management anticipates that this standard will be adopted in the Company's
financial statements for the period beginning January 1, 2013, and has not yet considered the potential impact of the adoption of IFRS 13.

IFRS 19 – Employee Benefits

IFRS 19 – Employee Benefits is effective for annual periods beginning on or after January 1, 2013 with early adoption permitted, sets out to eliminated the use of the "corridor" approach and mandates all remeasurement impacts be recognized in Other Comprehensive Income. It also enhances the disclosure requirements, providing better information about the characteristics of defined benefit plans and the risk that entities are exposed to through participation in those plans. This amendment clarifies when a company should recognize a liability and an expense for termination benefits. The Company is assessing the impact of this amended standard.

IAS 28 – Investments in Associates and Joint Ventures

The IASB also amended IAS 28, an existing standard, to include joint ventures in its scope and to address the changes in IFRS 10 to IFRS 12. The effective date of this amendment is for annual periods beginning on or after January 1, 2013. The Company does not anticipate this amendment to have a significant impact on its consolidated financial statements.

4. RESTRICTED CASH

Restricted cash represents compensating deposits held at banks to partially secure the Company's credit card accounts. The imposed restrictions dictate the funds are only allowed to be used to settle the Company's debt relating to credit card accounts.

5. RECEIVABLES

		June 30, 2012		December 31, 2011
Trade accounts receivable	$	**1,044,275**	$	230,810
Harmonized sales tax receivable		**24,019**		72,990
	$	**1,068,294**	$	303,800

At June 30, 2012 and December 31, 2011, no accounts receivable is due beyond one year. The fair value of amounts receivable approximates their carrying value as at June 30, 2012 and December 31, 2011.

(Expressed in Canadian Dollars)

6. PROPERTY AND EQUIPMENT

The following table presents details of movement in the carrying value of property and equipment by type:

Cost

	Office Equipment	Computer Equipment	Manufacturing Tooling	Leasehold Improvements	Total
Balance, December 31, 2011	**$ 63,435**	**$ 27,246**	**$ 39,151**	**$ 2,900**	**$ 132,732**
Additions	15,724	1,350	-	-	17,074
Disposals		(1,402)			(1,402)
Balance, June 30, 2012	**$ 79,159**	**$ 27,194**	**$ 39,151**	**$ 2,900**	**$ 148,404**

Accumulated Depreciation

	Office Equipment	Computer Equipment	Manufacturing Tooling	Leasehold Improvements	Total
Balance, December 31, 2011	**($ 43,204)**	**($ 21,879)**	**($ 19,576)**	**($1,450)**	**($ 86,109)**
Disposals	-	700	-	-	700
Depreciation	(5,101)	(1,595)	(9,788)	(1,088)	(17,572)
Balance, June 30, 2012	**($ 48,305)**	**($22,774)**	**($ 29,364)**	**($2,538)**	**($ 102,981)**

Net Book Value

	Office Equipment	Computer Equipment	Manufacturing Tooling	Leasehold Improvements	Total
Balance, December 31, 2011	$ 20,231	$5,367	$ 19,575	$ 1,450	**$ 46,623**
Balance, June 30, 2012	$ 30,854	$4,420	$ 9,787	$ 362	**$ 45,423**

Total depreciation for three months ended June 30, 2012 and 2011 was $6,702 and $9,557, respectively. Total depreciation for six months ended June 30, 2012 and 2011 was $17,572 and $19,114.

7. PATENTS AND INTELLECTUAL PROPERTY

The following table presents details of movement in the carrying value of the patents:

Cost

	Patents
Balance, December 31, 2011	**$ 341,170**
No changes	-
Balance, June 30, 2012	**$ 341,170**

(Expressed in Canadian Dollars)

7. PATENTS AND INTELLECTUAL PROPERTY (cont'd)

Accumulated Amortization

	Patents
Balance, December 31, 2011	**($ 225,260)**
Amortization	(13,122)
Balance, June 30, 2012	**($ 238,382)**

Net Book Value

	Patents
Balance, December 31, 2011	**$ 115,910**
Balance, June 30, 2012	**$ 102,788**

On August 31, 2003, the Company signed a technology agreement amended on February 10, 2004, for the purchase of certain patents, and the related intellectual property and know-how, in respect of a fluorescence scope system for dermatologic diagnosis.

At December 31, 2011, management had tested the intellectual property and intangibles for recoverability and no events or changes in circumstances indicated that the carrying values may not be recoverable. Therefore, there was no impairment of these assets at December 31, 2011. Total amortization for three months ended June 30, 2012 and 2011 was $6,561 and $13,127, respectively. Total amortization for six months ended June 30, 2012 and 2011 was $13,122 and $26,254, respectively.

8. TRADES PAYABLE AND ACCRUED LIABILITIES

	June 30, 2012	December 31, 2011
Trade payables	$ 1,590,374	$ 1,029,909
Accrued liabilities	496,288	377,220
Warranty provision	10,316	10,316
State sales tax payable	5,318	5,323
	$ 2,102,296	$ 1,422,768

9. DUE TO SHAREHOLDERS

			Total
Balance at December 31, 2011	**$ 52,272**	**$ 52,272**	**$ 104,544**
Accrued interest	1,293	1,293	2,586
Repayment	(53,565)	(53,565)	(107,130)
Balance at June 30, 2012	**$ -**	**$ -**	**$ -**

(Expressed in Canadian Dollars)

9. DUE TO SHAREHOLDERS (cont'd)

Advances from two shareholders received on August 31, 2010, bearing interest at 15% per annum, payable on demand and is secured by the investment tax credits recoverable. In conjunction with these loans, 120,000 common share purchase warrants were issued to the shareholders in lieu of any commitment, loan set-up or other fees.

Interest accrued on advances from shareholders during three and six months ended June 30, 2012 totaled $nil and $2,586 (three and six months ended June 30, 2011 - $14,558 and $37,875). As at June 30, 2012 the Company made principal and interest payments on the loans totaling $107,130 bringing the balance to $nil.

10. RELATED PARTY TRANSACTIONS

Transactions between the Company and its subsidiaries, which are related parties of the Company, have been eliminated on consolidation and are not disclosed in this note.

Related parties include key management, the Board of Directors, close family members and enterprises which are controlled by these individuals as well as certain persons performing similar functions.

In addition to the loans received from shareholders, and related interest accrual and payment, as described in Note 9, during the three and six months ended June 30, 2012 and 2011, the Company paid or accrued the following compensation expenses to key personnel of the Company:

	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
Short-term compensation*	$ 109,587	$ 118,055	$ 222,528	$ 269,238
Post employment benefits	$ Nil	$ Nil	$ Nil	$ Nil
Other long-term benefits	$ Nil	$ Nil	$ Nil	$ Nil
Termination benefits	$ Nil	$ Nil	$ Nil	$ Nil
Share-based payments	$ Nil	$ Nil	$ Nil	$ Nil

(*) Included in short-term compensation are consulting fees paid to the former CFO as well as royalties accrued in relation to the employment agreement with the current CEO (see Note 11(g)).

During the three and six months ended June 30, 2012, and 2011, there were no options awarded to directors and key management under the Company's stock option plan.

(Expressed in Canadian Dollars)

11. LEASE OBLIGATIONS AND COMMITMENTS

a) The Company has a capital lease with respect to the purchase of office equipment. The Company has the option to purchase the equipment for a nominal purchase price at the end of the lease.

Future minimum lease payments together with the balance of the capital lease obligation are as follows:

	June 30, 2012	December 31, 2011
Payable not later than one year	$ 4,956	$ 4,956
Payable later than one year and not later than five years	11,004	13,482
	15,960	18,438
Less future finance charges	(4,515)	(5,820)
Present value of minimum lease payments	11,445	12,618
Current portion	**(2,756)**	**(2,478)**
Long term portion	**$ 8,689**	**$ 10,140**

b) The Company had leases with respect to its operating premises in Burnaby, BC. Future minimum lease payments as at June 30, 2012 are as follows:

Payable not later than one year	$ 13,915
Payable later than one year and not later than five years	-
Total future minimum lease payments	**$ 13,915**

c) The Company was paying royalties at a rate of 1.5% of VELscope sales to the British Columbia Cancer Agency prior to December 31, 2010. The rate was subsequently revised to 0.75% and retroactively applied to prior periods resulting in a reversal of previous accruals. During three months ended June 30, 2012, the Company reduced royalties of $21,310 (three months ended June 30, 2011 – $14,564 of royalties was accrued). During six months ended June 30, 2012, the Company reversed royalties of $11,660 (six months ended June 30, 2011 – $28,291 royalties was accrued). As at June 30, 2012, total royalties accrued but not paid was approximately $90,600.

d) On June 4, 2010, the Company entered into an 18 month corporate sponsorship agreement with a dental industry professional association beginning July 1, 2010. Under the terms of the sponsorship agreement, the Company was committed to total payments of U.S. $131,965 over the term of the agreement payable in quarterly payments starting September 2010. As of December 31, 2011, the agreement ended. During the three months ended June 30, 2012, U.S. $nil was accrued or paid (three months ended June 30, 2011 – U.S. $21,833). During the six months ended June 30, 2012, U.S. $15,246 was accrued or paid (six months ended June 30, 2011 – U.S. $43,827). As of June 30, 2012, the balance outstanding was $nil.

e) On November 30, 2010, the Company entered into a 2 year renewable sales and marketing agreement with a distributor (the "Distributor") of medical and dental supplies whereby the distributor would be granted exclusive rights to market the VELscope in Canada, the United States, and Puerto Rico. The Distributor also has a right of first refusal to be granted exclusive rights to market the VELscope to the world outside of the original territory should the Company wish to expand distribution. Under the agreement, the Distributor is entitled to receive rebates ranging from 5% to 10% of the unit prices upon achieving certain milestones for units purchased. The Distributor will also receive up to 2,541,468 share purchase warrants at $0.65 per share, based on the Distributor achieving certain sales milestones. The Distributor achieved the first milestone as at December 31, 2011 by selling in excess of 3,000 units. As such, 635,637 warrants were exercisable and had been allocated a fair value of $162,262.

(Expressed in Canadian Dollars)

11. LEASE OBLIGATIONS AND COMMITMENTS (cont'd)

The Distributor has not completed the second milestone as at June 30, 2012.

Further, during the year ended December 31, 2010, the Distributor returned certain units of VELscope Model V2, a legacy unit, at a value of U.S. $292,600. The Company has agreed to provide a credit in such amount, which shall be applied against the price of parts and accessories purchased by the Distributor and related to the VELscope Model V2, to a maximum of 60% of the price of parts and accessories for each purchase order. At June 30, 2012, included in accounts payable is U.S. $111,857 (December 31, 2011 – U.S. $166,344) representing the credit for the Distributor.

f) The Company warrants that its products will operate substantially in conformity with product documentation. The specific terms and conditions of the warranties are generally two years for the original VELscope units and one year for the new VELscope Vx units sold to customers. The Company accrues for known warranty issues if a loss is probable and can be reasonably estimated, and accrues for estimated incurred but unidentified warranty issues based on historical activity. To date, the Company has had no material warranty claims. Included in trades payable and accrued liabilities as of June 30, 2012 is $10,316 (December 31, 2011 - $10,316) representing a warranty provision.

g) On January 1, 2011, the Company entered into an employment agreement with the CEO of the Company whereby the CEO would be paid an annual salary of $250,000 and will receive royalties of 2% of all VELscope sales until January 1, 2018. Further, the CEO will receive bonuses and options as follows:

- $25,000 and 250,000 options once the annual earnings before interest, tax and amortization ("EBITDA") reaches $1,000,000; and
- $100,000 and 250,000 options once the EBITDA reaches $2,000,000.

The Company accrued royalties of approximately $25,400 during the three months ended June 30, 2012 (three months ended June 30, 2011 - $25,800). The Company accrued royalties of approximately $51,400 during the six months ended June 30, 2012 (six months ended June 30, 2011 - $83,000). As at June 30, 2012, total royalties accrued but not paid was approximately $159,500.

h) The Company may be subject to a variety of claims and suits that arise from time to time in the ordinary course of business. These matters are subject to inherent uncertainties. To date, the Company is aware of a wrongful dismissal lawsuit initiated by a former employee who is seeking up to $185,000 in salaries and bonuses. Management believes the claim is without merit and will defend it vigorously.

12. SHARE CAPITAL

Authorized share capital

Unlimited number of common shares without par value

	Number of common shares	Amount
Outstanding, December 31, 2011	**36,335,508**	**$24,116,479**
No transactions during the period	-	-
Outstanding, June 30, 2012	**36,335,508**	**$24,116,479**

12. SHARE CAPITAL (cont'd)

2011

On February 22, 2011 the Company completed a unit offering at $0.75 per unit, consisting of one common share and one-half common share purchase warrant, exercisable for 18 months, at $1.00. Pursuant to this offering, the Company issued 2,029,999 common shares for gross proceeds of $1,522,461. The Company does not separate the value of the warrants from the units issued.

As of June 30, 2012, a total of 5,173,877 (December 31, 2011 – 6,238,653) common shares were held under escrow. The remaining common shares will be released from escrow at a rate of 15% every 6 months, over a period of 36 months.

13. STOCK OPTIONS

Commencing in 2005, the Company has granted, by way of directors' resolutions, stock options to directors, officers, employees and other service providers at the exercise price set out at the grant date. The Company has a rolling incentive stock option plan. Under the terms of the Company's stock option plan, the Board of Directors may grant options to directors, officers, employees, consultants and service providers equal to 10% of issued and outstanding common shares of the Company from time to time on a rolling basis. The plan provides for the granting of options at the closing price of the Company's stock on the day prior to the grant date. The option plan states that the Board of Directors are the administrators of the plan with defined vesting period for options granted. As part of the Searchlight transaction that occurred in late 2011, all stock options were cancelled except for the Agents' Options.

A summary of the Company's outstanding share options is presented below:

	Outstanding options	
	Number of common shares	**Weighted average exercise price (in U.S. dollars)**
Outstanding, December 31, 2011	**330,000**	**$ 1.54**
There were no transactions during the period	-	-
Outstanding, June 30, 2012	**330,000**	**$ 1.54**

14. WARRANTS

The following table summarizes the warrant transactions that occurred during the period:

	June 30, 2012	
	Number of Warrants	**Weighted average exercise price**
		($)
Warrants outstanding, beginning of period	8,971,968	0.72
No activity during the period	-	-
Warrants outstanding, end of period	**8,971,968**	**0.72**
Warrants exercisable, end of period	**7,065,867**	**0.74**

(Expressed in Canadian Dollars)

14. WARRANTS (cont'd)

The following table summarizes information about the Company's warrants outstanding at June 30, 2012:

	Warrants Outstanding		Warrants Exercisable	
Exercise prices ($)	**Number Outstanding**	**Weighted Average Remaining Term (Years)**	**Number Exercisable**	**Weighted Average Remaining Term (Years)**
0.65	7,246,368	0.48	5,340,267	0.43
1.00	1,725,600	0.81	1,725,600	0.81
	8,971,968	**0.55**	**7,065,867**	**0.53**

The Company entered into a distribution agreement with its North American distributor which provides for the issuance of warrants to purchase the Company's shares at a price of $0.65 per common share for a three year period after issuance which is subject to the achievement of sales volume performance milestones by the distributor over a three year term (see Note 11). The total number of warrants of 2,541,468 are to be issued in four equal tranches subject to achievement of the sales volume milestones. As of June 30, 2012, only the first milestone has been achieved. As such, only 635,367 warrants are exercisable. Subsequent to June 30, 2012, 120,000 warrants, with an exercise price of $0.65, expired.

15. INCOME (LOSS) PER SHARE

	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
Weighted average number of shares outstanding – basic	36,335,508	31,208,524	36,335,508	30,628,524
Dilutive effects of exercisable options and warrants	-	-	-	-
Weighted average number of shares outstanding – fully diluted	**36,335,508**	**31,208,524**	**36,335,508**	**30,628,524**

The weighted average number of shares outstanding for purposes of calculating basic income (loss) per share for the three months ended June 30, 2012 was 36,335,508 (three months ended June 30, 2011 – 31,208,524). For the six months ended June 30, 2012 and 2011, no shares were added as the Company was in a net loss position for the period resulting in an anti-dilutive quantification (note 3).

For the fully diluted income per share calculation for the three months ended March 30, 2012, no shares were added to the weighted average number of common shares outstanding during the periods for the dilutive effects of exercisable stock options and warrants as none had a strike price that was lower than the average stock price for above mentioned periods.

(Expressed in Canadian Dollars)

16. SEGMENTED INFORMATION

In each respective period, revenues from customers which amounted to 10% or more of the Company's revenues accounted for the following percentages of the Company's total revenues. The majority of the Company's revenues are primarily attributable to its North American distributor:

	% of Revenues for the three months ended June 30, 2012	% of Revenues for the six months ended June 30, 2012	% of Accounts Receivable at June 30, 2012	% of Revenues for the three months ended June 30, 2011	% of Revenues for the six months ended June 30, 2011	% of Accounts Receivable at June 30, 2011
Distributor	91%	90%	91%	93%	89%	-%
Total	**91%**	**90%**	**91%**	**93%**	**89%**	**-%**

The Company earned revenues attributed to the following geographical regions based on the location of the customer:

	Three months ended June 30, 2012	%	Three months ended June 30, 2011	%	Six months ended June 30, 2012	%	Six months ended June 30, 2011	%
North America	$ 1,651,388	92%	$1,505,804	100%	$ 3,344,786	92%	$ 4,564,759	100%
Rest of World	141,019	8%	1,200	<1%	276,612	8%	1,200	<1%
	$1,792,407	**100%**	**$1,507,004**	**100%**	**$ 3,621,398**	**100%**	**$ 4,565,959**	**100%**

For the three months and six months ended June 30, 2012 and 2011, the Company continues to generate the majority of its revenue from North America.

17. CAPITAL DISCLOSURES

The Company's objectives for managing capital are:

- To safeguard the Company's ability to continue as a going concern, so that it can provide adequate returns for shareholders and benefits for other stakeholders;
- To fund capital projects for facilitation of business expansion provided there is sufficient liquidity of capital to enable the internal financing; and
- To maintain a capital base so as to maintain investor, creditor and market confidence.

The Company considers the items included in the consolidated statements of shareholders' equity as capital. The Company manages the capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust the capital structure, the Company may issue new shares or return capital to shareholders. The Company is not subject to externally imposed capital requirements.

(Expressed in Canadian Dollars)

18. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Company is exposed in varying degrees to a variety of financial instrument related risks. The Board of Directors approves and monitors the risk management processes, inclusive of documented investment policies, counterparty limits, and controlling and reporting structures. The type of risk exposure and the way in which such exposure is managed is provided as follows:

Classification of financial instruments

Financial assets included in the statement of financial position are as follows:

	June 30, 2012	December 31, 2011
Cash and cash equivalents		
Cash and cash equivalents	$ 767,677	$ 992,360
Restricted cash	5,000	25,000
Loans and receivables:		
Receivables	1,068,294	303,800
	$ 1,840,971	$ 1,321,160

Financial liabilities included in the statement of financial position are as follows:

	June 30, 2012	December 31, 2011
Non-derivative financial liabilities:		
Trades payable	$ 1,590,374	$ 1,029,909
Due to shareholders	-	104,544
Capital lease obligations	11,445	12,618
	$ 1,601,819	$ 1,147,071

Fair value

The fair value of the Company's financial assets and liabilities approximates their carrying amount.

Financial instruments measured at fair value are classified into one of three levels in the fair value hierarchy according to the relative reliability of the inputs used to estimate the fair values. The three levels of the fair value hierarchy are:

- Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly; and
- Level 3 – Inputs that are not based on observable market data.

Financial instruments classified as Level 1 – quoted prices in active markets include cash and cash equivalents.

Credit Risk

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss. The Company is exposed to credit risks arising from its cash holdings and receivables. The Company manages credit risk by placing cash with major Canadian financial institutions. Receivables are due for completed sales and reimbursements. Management believes that credit risk related to these amounts is low.

(Expressed in Canadian Dollars)

18. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (cont'd)

The Company monitors collectability of receivables on an on-going basis to determine credit risk. In order to mitigate credit risk, the Company offers credit terms to established customers. Other customers are required to pay in advance or by credit card, prior to shipping of the product. At June 30, 2012, no accounts receivable are due beyond one year.

As at June 30, 2012 and December 31, 2011, the Company's exposure to credit risk for these financial instruments was as follows:

	June 30, 2012	December 31, 2011
Cash and cash equivalents	$ 767,677	$ 992,360
Restricted cash	5,000	25,000
Receivables	1,068,294	303,800
	$ 1,840,971	$ 1,321,160

Receivables (related to trade accounts receivable) balances of $1,044,275 (December 31, 2011 - $230,810) were aged as follows as at June 30, 2012 and December 31, 2011. It does not include harmonized sales tax receivable of $24,019 as at June 30, 2012 (December 31, 2011 - $72,990).

Included in the balance as at June 30, 2012 was $946,443 which was related to the net accounts receivable balance of the Distributor. The Distributor's accounts receivable balance of $1,475,418 was netted against its accounts payable balance of $528,975.

	June 30, 2012	December 31, 2011
Current	$ 493,212	$ 776
31-60 days	507,284	65,491
Over 60 days	43,779	164,543
	$ 1,044,275	$230,810

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company has a planning and budgeting process in place to help determine the funds required to support the Company's normal operating requirements on an ongoing basis. The Company ensures that there are sufficient funds to meet its short-term business requirements, taking into account its anticipated cash flows from operations and its holdings of cash and cash equivalents.

To manage liquidity risk, the Company reviews additional sources of capital to continue its operations and discharge its commitments as they become due. Historically, the Company's sole source of funding has been the issuance of equity securities for cash, primarily through private placements.

Trades payable was aged as follows as at June 30, 2012 and December 31, 2011 and does not include accrued liabilities of $496,288, warranty provision of $10,316 and state sales tax payable of $5,318 as at June 30, 2012 (December 31, 2011 - $377,220, $10,316 and $5,323 respectively).

(Expressed in Canadian Dollars)

18. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (cont'd)

	June 30, 2012	December 31, 2011
Current	$ 746,615	$ 296,326
31-60 days	341,051	119,583
Over 60 days	502,708	614,000
	$ 1,590,374	$1,029,909

The following is an analysis of the contractual maturities of the Company's non-derivative financial liabilities as at June 30, 2012:

	Within one year	**Between one and five years**
Trades payable	$ 1,590,374	$ -
Capital lease obligations	2,756	8,689
	$ 1,593,130	**$ 8,689**

Interest rate risk

Interest rate risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Interest rate risk is limited to the portion of the Company's cash held in bank accounts that earn interest. Due to the limited and short term nature of these financial instruments, fluctuations in the interest rates will not have a significant impact on their fair value. As at June 30, 2012, the Company had not entered into any derivative contracts to manage this risk.

Currency risk

The Company is exposed to the financial risk related to the fluctuation of foreign exchange rates. The Company operates in Canada and the United States. The Company's functional currency is the Canadian dollar. The Company has not hedged its exposure to currency fluctuations.

Assuming that all other variables remain constant, a 10% change in the value of the Canadian dollar against the U.S. dollar would not materially affect the loss from operations.

19. OTHER OPERATING EXPENSES

Other operating expenses consist of the following:

	Three months ended June 30, 2012	**Three months ended June 30, 2011**	**Six months ended June 30, 2012**	**Six months ended June 30, 2011**
Depreciation of equipment	$ 6,702	$ 9,557	$ 17,572	$ 19,114
Amortization of intangible assets	6,561	13,127	13,122	26,254
	$ 13,263	$ 22,684	**$ 30,694**	$ 45,368

(Expressed in Canadian Dollars)

20. EXPENSES BY NATURE

While expenses are presented by function, the table below reconciles the Company's expenses by function to expenses by nature which were originally provided for the three months ended June 30, 2011.

	Three months ended June 30, 2011	Six months ended June 30, 2011
Amortization of intangible assets	$ 13,127	$ 26,254
Business development	357,408	586,409
Consulting fees	124,905	254,158
Depreciation of equipment	9,557	19,114
Insurance	10,667	28,493
Interest and bank charges	23,019	59,894
Office	31,897	85,982
Professional fees	96,028	240,361
Rental	31,544	65,163
Research and development, net of investment tax credits	28,015	75,664
Salaries and wages	709,046	1,170,103
Telephone	12,992	26,000
Travel	65,432	111,693
Warranty	13,942	21,052
	$ 1,527,579	**$ 2,770,340**

For the three and six months ended June 30, 2012, total salaries and wages were $429,279 and $1,022,247, respectively (three and six months ended June 30, 2011 - $709,046 and $1,170,103).

21. RESTATEMENT

The Company restated its financial statements for the year ended December 31, 2010, in order to record:

a) An advance which was included in cost of goods sold at December 31, 2010;
b) Revenues recorded in fiscal 2010 but relate to the year ended December 31, 2011;
c) Trades payable and accrued liabilities relating to the fiscal year 2010; and
d) All legal costs relating to patents (incurred since patents acquired) under IFRS should have been expensed, not capitalized.

	Three months ended June 30, 2011 – As previously reported	Adjustments	Three months ended June 30, 2011
Interim condensed consolidated statements of cash flows			
Working capital adjustments			
Receivables	$ 2,063,342	$ 43,278	$ 2,106,620
Trades payable and accrued liabilities	$ 197,347	($ 43,278)	$ 154,069

(Expressed in Canadian Dollars)

21. RESTATEMENT (cont'd)

	Six months ended June 30, 2011 – As previously reported	Adjustments	Six months ended June 30, 2011
Interim condensed consolidated statements of cash flows			
Working capital adjustments			
Receivables	($ 368,885)	$ 43,278	($ 325,607)
Trades payable and accrued liabilities	$ 900,691	($ 43,278)	$ 857,413
Interim condensed consolidated statements of shareholders' equity (deficit)			
Share capital	$ 20,756,959	($ 13,151)	$ 20,743,808
Deficit	($ 21,681,243)	($ 139,893)	($ 21,821,136)